When the mind plays tricks!

Edward Leamer, famous for his 1983 article in the American Economic Review, "Let´s take the con out of econometrics", in January 2007, published an essay "Is a Recession Ahead? The Models Say Yes, but the Mind Says No". To him, "Housing is the business cycle", so he syas:

> Any model built on housing starts is **sure to say a recession is coming soon**. But, the curmudgeon jokes: "Economists are like artists. They tend to fall in love with their models." With considerably less pleasure, I would add.

Further on, he writes:

> Thus, when your mind tells you that your model is going astray, listen carefully. Eliminate the wishful thinking and all that remains are the insights.

His strategy was to "consider 1760 models involving three of thirteen indicators in all different combinations. The model that fits the data best predicts recessions from (1) **the interest rate spread**, (2) building permits, and (3) the unemployment rate.

> According to this model, the probability of a recession in one year rose to 86 percent in January 2006 and to 100 percent in March 2006, and has been stuck at 100 percent through October 2006. According to this (imperfect) predictive probability, a recession is a virtual certainty and likely to commence in the first quarter of 2007.

And states:

> The models that rely on history suggest that the extreme problems in housing currently being corrected will **almost surely infect the rest of the economy**, but that history does not take into account two important facts:
>
> - Manufacturing is not poised to contribute much to job loss.

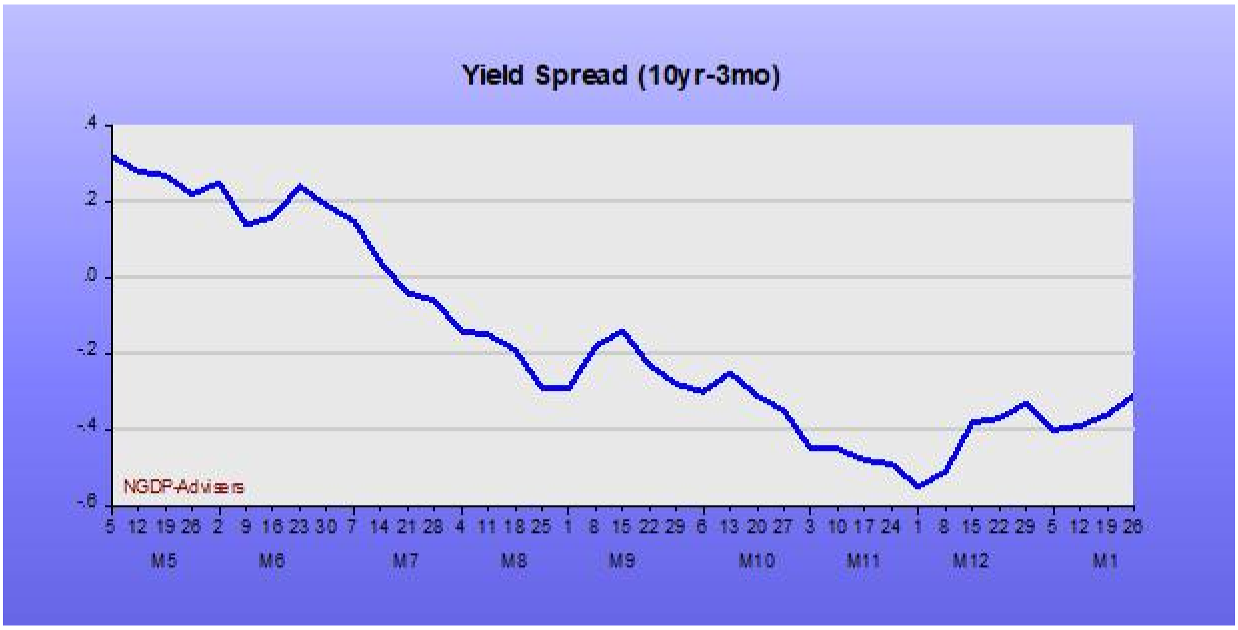
- Real interest rates are very low and there is no **evident credit crunch, now or on the horizon**.

> These facts make the problem in housing less severe than it would be otherwise, and help to **confine the pathology to the directly affected real estate sectors: builders, real estate brokers and real estate bankers.**

Concluding:

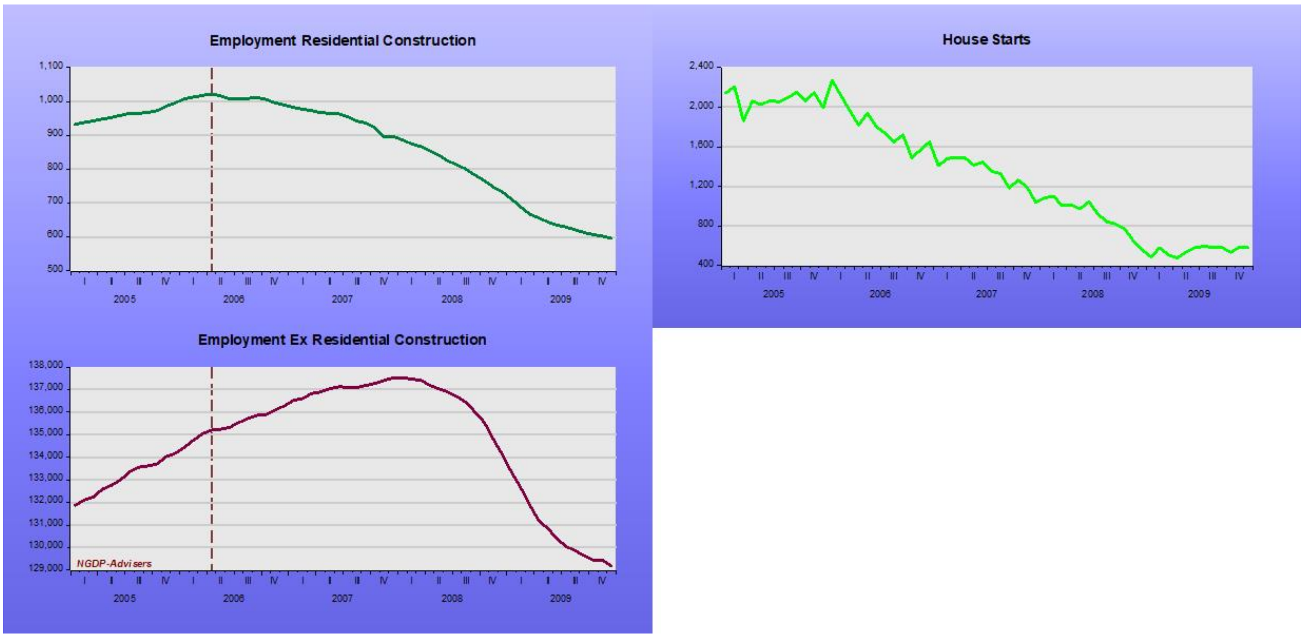
> The models say “recession;” the mind says “**no way**.” I’m going with the mind. This time the problems in housing will stay in housing. If you are a builder or a broker, it will feel like a deep depression. **The rest of us will hardly notice**.

With his laser focus on housing, he “missed” the “best” predictor of recession. A negative yield spread was already a fact by October 2006 (which I assume was in his information set). The chart illustrates.



Even so, maybe Leamer wasn´t far off the mark. A mild recession, “hardly noticed by the rest of us”, could have been the outcome.

As the next set of charts show, after residential construction employment began to fall, led by the fall in housing starts, overall payrolls, excluding residential construction, remained on an upward trend.

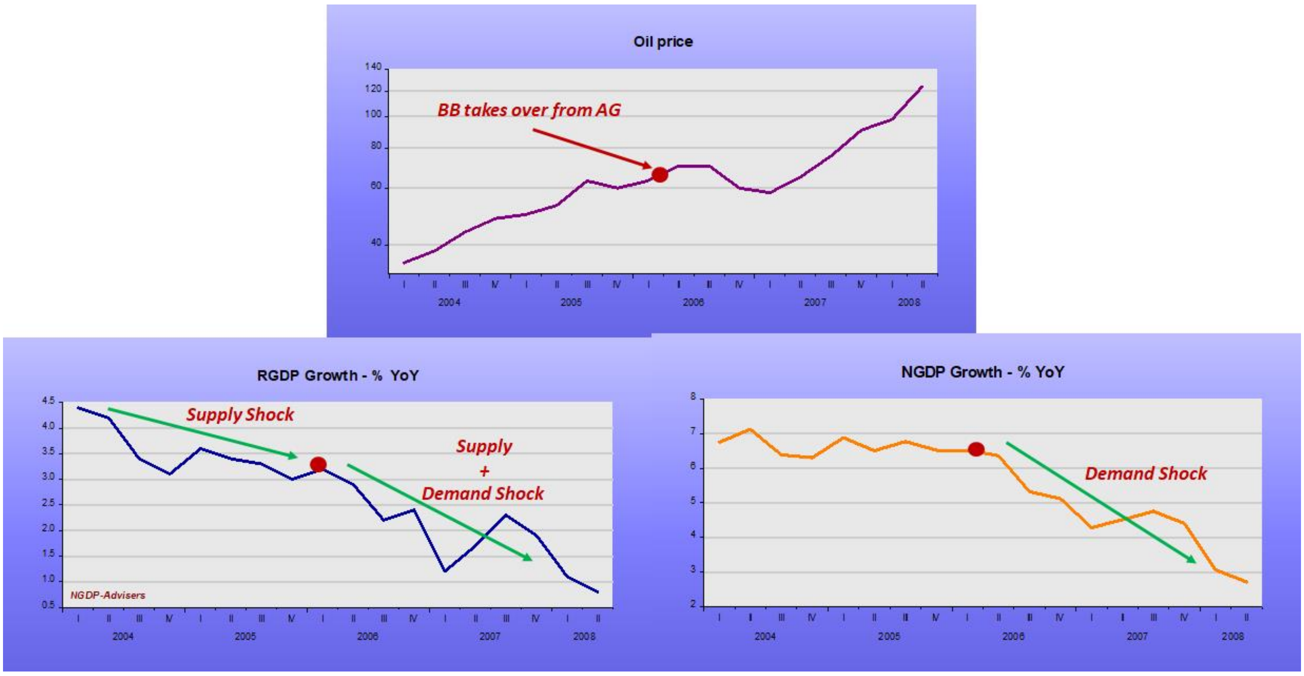


All that changed by mid-2008. At that point, payrolls took a nosedive. At that point, house prices had already dropped a little over 50%. Maybe the second leg of the house price fall wouldn´t have materialized if the economy as a whole had not tanked.

What wasn´t in Leamer´s “lifetime” information set? The plunge in nominal spending (NGDP) growth, which occurred after mid-2008!

The charts tell a convincing story. From 2004 to mid-2008 the economy was buffeted by a strong and protracted oil price (a supply) shock. Well-grounded theory tells us this will have a negative impact on real growth (and a positive impact on inflation). The best response of the central bank is to keep nominal spending growth on an even keel.

Alan Greenspan (AG) managed to keep NGDP growth stable. When Bernanke (BB) took over, maybe because of his obsession with inflation, nominal spending growth began to fall before plunging. That´s when the recession became “Great” and everyone not only felt it, but also suffered deeply from it!



The sad part is that after 10 years, the monetary nature of the problem is rarely acknowledged, with the result the economy remains deeply depressed!